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DOW THEORY LETTERS INC.

"The Market as Interpreted under the Dow Theory"

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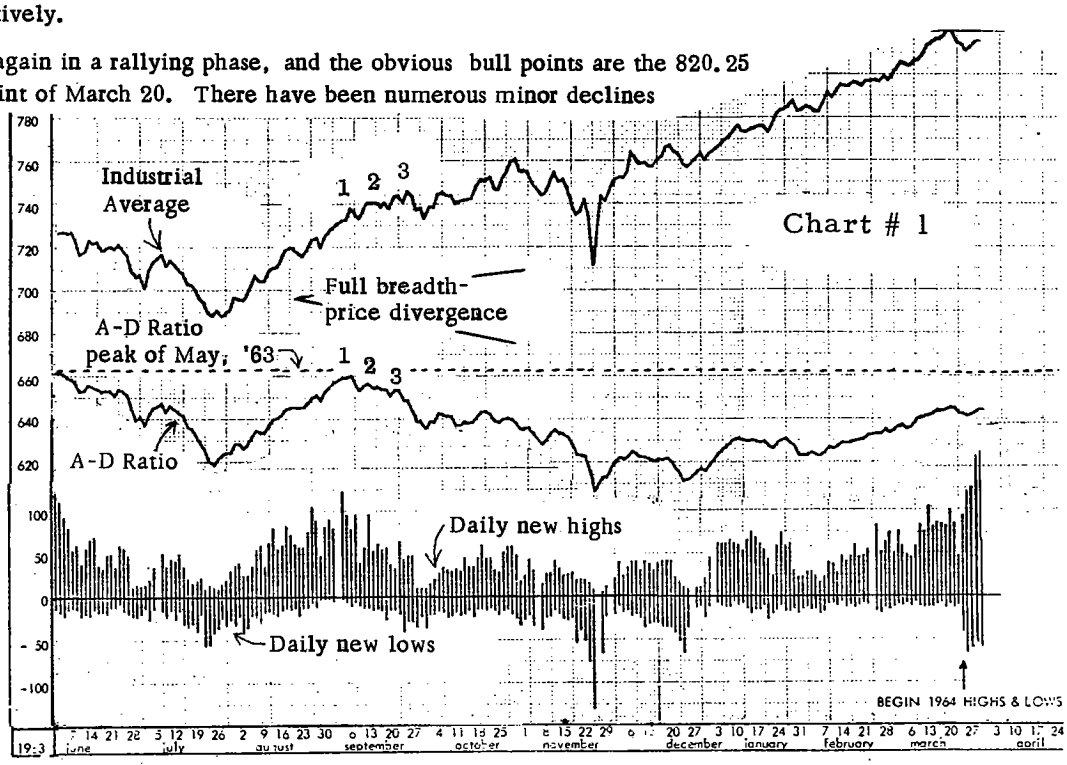
THE MARKET: The most useful thing about a decline, even a minor decline, is that it forces the market to reconfirm its last direction. On March 18 the Industrial Average recorded an all-time high of 820.25 (chart 2). On March 19 the advance-decline ratio struck a recovery peak of its own (although the March peak was well under the 1963 highs for this index — see chart 1). On March 20 the Rail Average touched an all-time high of 193.47. During the next few days the Industrial and Rail averages declined to 811.43 and 191.17 respectively.

As this is written, the Averages are again in a rallying phase, and the obvious bull points are the 820.25 mark of March 18 and the 193.47 point of March 20. There have been numerous minor declines and subsequent successful upside penetrations since late 1962, and from all appearances this is to be "just another such performance." The widely-held opinion is that the Averages will be substantially higher by late spring, and if there are any who doubt this, they do not readily put their unpopular views into print. Despite the current optimism, when an advance has carried this far for this long, it is wise to attach less and less validity to the rule that "the trend continues in force until proved otherwise." From my own standpoint, I note that it is taking more and more volume to do less and less (actually, Industrials are up only about 2% since the signing of the tax bill, while Rails have made no net progress and Utilities are down). Therefore, I would prefer to see the Averages themselves clear the 820.25 and 193.47 levels, rather than forecast that such a reconfirmation is "in the bag."



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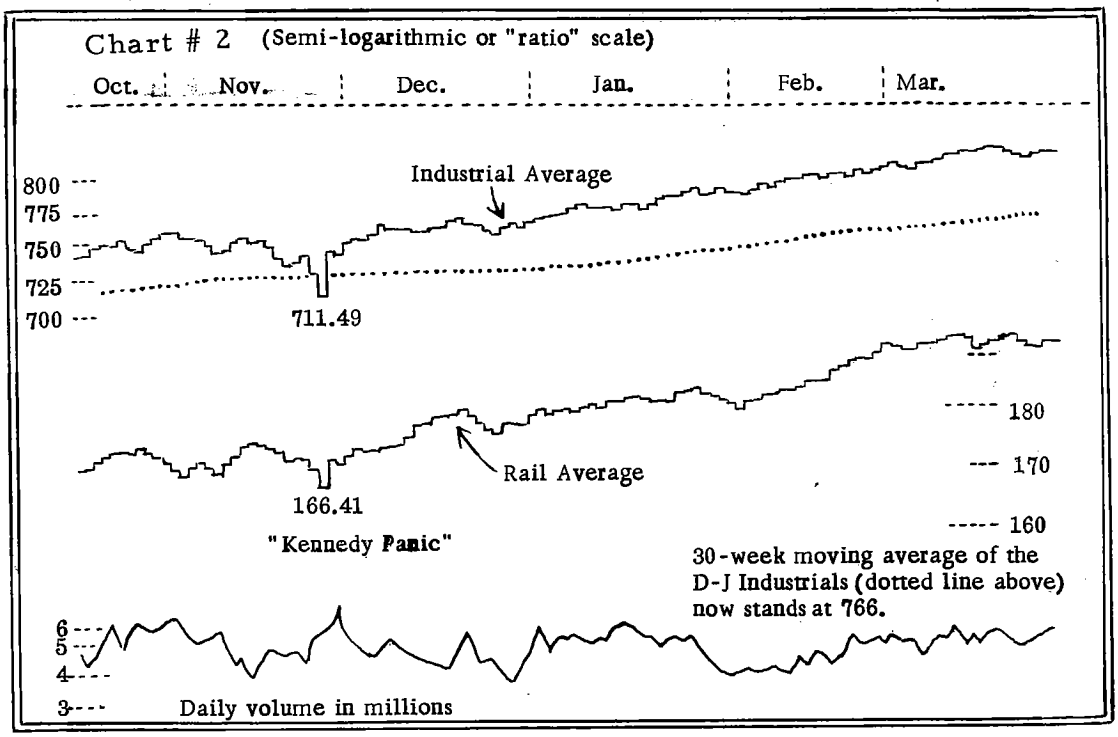
I have been watching one particular gauge of the market with considerable interest, and it has just shown what may be a most important change. As those who have read either of Dr. Sloan Wilson's books know, during an important market advance it is normal to see the professional speculator steadily



expand his holdings. The speculator's most important "tool" is his margin account (i.e., debit balance in Wall Street parlance), and during an advance the total of debit balances on the N.Y.S.E. tends to rise higher and higher. Such action implies that the professionals are solidly behind the advance, and as long as this is the case, the advance can be expected to continue. Important turning points in the market, in fact, have often occurred simultaneously with important peaks and subsequent downturns in the debit balances. The recent reading of the debit balances are included below, and it is most important to note that the latest figures show a drop of $141 million. This takes the debit balances down to their lowest reading since September, 1963.

Debit balances in $ billions: June, 1963, 4.898; July, 4.895; August, 5.034; September, 5.315; October, 5.486; November, 5.587; December, 5.515; January, 1964, 5.524, February, 5.405. (The two Wilson books are "The Speculator and the Stock Market", and "Public Participation in the Stock Market" — both books are available here).

QUESTION: "You have stated that the stocks which make up the Industrial Average are now priced very dearly in the light of history. You have further compared the current 'overvaluation' with such periods as 1929. But how about the erosion in the purchasing power of the dollar? Since today's dollar is worth only a fraction of the 1929 dollar, shouldn't the Industrial Average be adjusted accordingly? In this light, perhaps stocks are not so dear as you suggest." (E.S., Beverly Hills, California).

ANSWER: A basic tenet of Dow's Theory is that the Averages automatically adjust themselves to all events and conditions. This means that the Averages will adjust to changes in earnings, psychology, politics, the effects of disaster — everything including inflation.

In 1949 the D-J Industrial Average earned $23.54 and sold that year within a range of 6.8 to 8.5 times earnings. This represented an area of great value and depressed investor psychology. It has been estimated that the Dow will earn about $43.00 this year, and on this basis it is selling at about 19.3 times earnings. If the Dow were now to sell at the highest price-earnings ratio of 1949, it would sell for 365. Then why, we ask ourselves, is the Dow currently selling for more than twice the peak price-earnings ratio of 1949. The answer is (1) the current price of the Dow reflects a great rise in investor optimism and enthusiasm, (2) the current price also reflects the efforts by investors to protect themselves against the inroads of inflation.

The following question might now be asked: with fourteen years of prosperity and inflation ahead of it, how could the market have sold on such a bargain basis in 1949? The answer, of course, is that in 1949 no one foresaw the extent of the boom which was to occur during the 1950's and '60's. Thus, the market has spent the past 14 years discounting conditions which are only apparent today. All of which leaves us with another question: after 14 years of rising price-earnings ratios, what can we expect next? My own guess is that investors today may be just as oblivious of the possibility of declining economic conditions as they were oblivious to rising business conditions in 1949 — at which time the Dow sold for as low at 6.8 times that year's earnings.

A MARKET TO WATCH: The vastness of the U.S. Treasury Bond market is not generally appreciated. Ths U.S. has approximately 88 billion outstanding in long-term bonds (maturities of five years or over) plus another 56 billion outstanding in notes (maturities of from one to five years). Finally, (not counting savings bonds) the U.S. has about 53 billions outstanding in bills (maturities of less than one year).

The importance of this mountain of bonds, notes and bills can further be appreciated when we realize that the bulk of the U.S. debt is held by banks, institutions and wealthy individuals. It follows that major movements in the price of Treasury bonds can have a significant effect on the psychology of these large investors and institutions.

A major decline in Treasury Bond prices, in fact, may have a two-fold effect: (1) A decline may result in losses of hundreds of millions of dollars in institutional, bank and investment portfolios. (2) A declining bond market (with concurrent rising bond yields) will exert an increasingly competitive pressure on the stock market (and this is particularly true if the stock market happens to be on a low yield or "overvalued" basis). For instance, at this time an investor may have his choice of purchasing a cross-section of the D-J Industrial stocks at an average yield of 3.26%, or he can purchase municipal bonds at an average tax-free yield of about 3.35% or he can purchase a long list of U.S. Treasury bonds (one of the world's safest investments) at average yields ranging up to 4.24%.

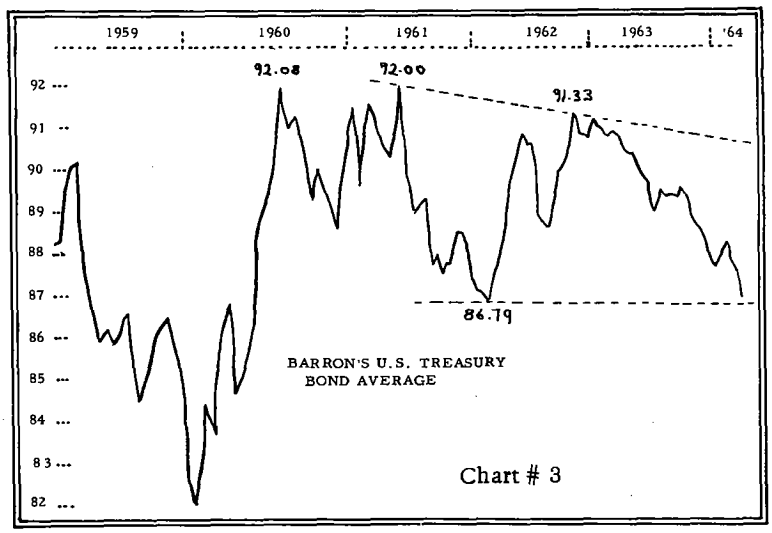


Chart # 3

Because stocks are now on a very low-yield basis and because bonds are now on a high-yield basis, it will be worth paying particular attention to the trend of Treasury bond prices from this point on. I have mentioned in past Letters that I believe Barron's Treasury Bond Index is in the process of forming an extended and very important "top". Chart # 3, which traces the path of the bond index since

1959, would seem to bear out this thesis.

The late-1959 weakness in bonds (see chart) lead to chaotic conditions in the Government market, and the result was the famous "Magic Fives", a series of notes of five-year maturity bearing the sensational interest rate of 5%. This was an admission that the Government was in a bind, and the attraction of 5% terms proved irresistable. Along with tremendous (and newly-aroused) public interest in the bond market, the D-J Industrial Average toppled 120 points.

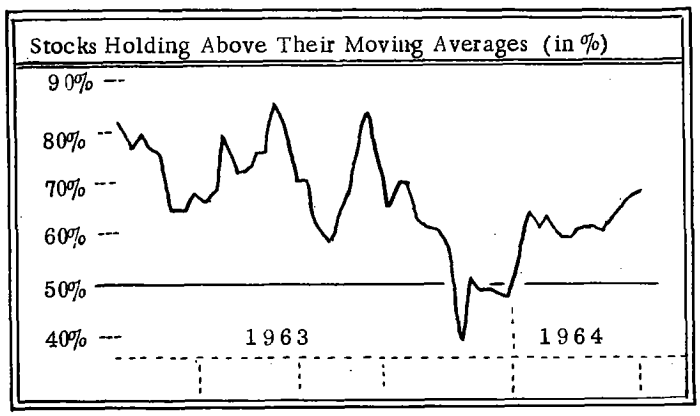
Interest rates were promptly eased, and the bond market headed up. In August, 1960, Barron's Index rose to a high of 92.08. A decline ensued, but during early 1961 the Index again pushed up. A second peak occurred in mid-1961 at 92.00 (just 8¢ under the 1960 peak). This "double top" was followed by an important decline to a low of 86.79 recorded in February, 1962 (just prior to the 1962 stock market crash).

The recovery from the 1962 low took Barron's Bond Index to an October, 1962, peak of 91.33, and at that time I wrote that it appeared we were making a third important top in the Treasury Index. The Index turned down in late-1962, and it has been declining ever since.

It is notable that the current decline differs substantially from all previous declines. This decline in bonds stems not from a "tightening money policy" out of Washington, it is occurring in response to a general rising level of bank rates throughout the free world. In the last few months, there have been increases in the discount rates of England, Italy, Japan, Belgium, Sweden, Netherlands, and France. The European nations (who have had ample experience with the disaster of galloping inflation) have decided to fight inflation with "hard money". This leaves the U.S. with an inflation-oriented discount rate of 3 1/2%, and the choice of a possible exit of U.S. funds in search of more attractive foreign rates or a second choice of raising our own interest rates in self-defence (an act which the bond market now appears to be discounting).

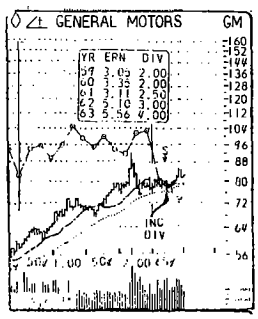
I feel that it is now most important to fix our eyes on the 86.79 low of Barron's Treasury Index, established in early 1962. If this level is broken, it will suggest to me that the whole bond structure is giving way, and that something almost as dramatic as the magic fives may be in the offing.

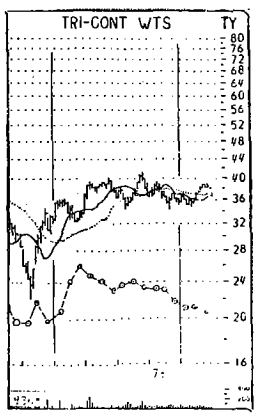
Perhaps a "preview" of the fast-moving money situation is last week's announcement by the Treasury of a new 4.10% note to mature in 16 months. According to the Wall Street Journal, "Under Secretary Roosa expressed displeasure that market conditions require the Treasury to pay a rate that high."



STOCKS: Of 432 stocks which are tabulated weekly at this office (see chart), 293 (68%) are now holding above their 200-day (30-week) moving average. This is a gain of 1% since last week, and this study will remain bullish as long as the percentage holding above the moving average is above 50%.

TWO BELLWETHERS of the market continue to act unsatisfactorily. Five months have passed since the (late-October) all-time high in General Motors. In the past, when GM has recorded a peak and has not been able to better that peak in the following 4-6 months, it has been an ill omen for the entire market. Thus, the current action in GM is spelling "danger". Note on the chart that the latest rise in GM has not attracted the volume which was present during the October, 1963, all time high. Moreover, GM's short position (circles connected with lines on chart) has fallen to its lowest point in over a year (this is not encouraging). In order to completely break down, however, GM would have to decline to 76 or below.

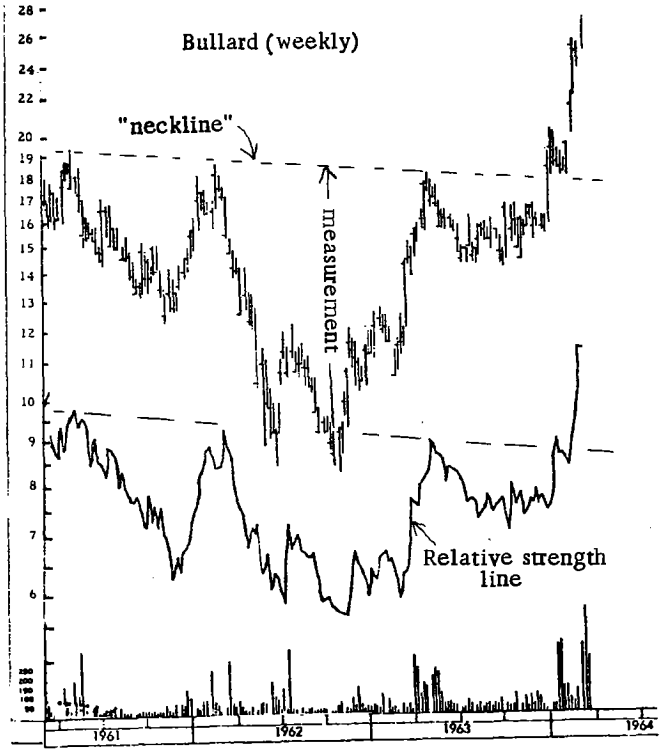




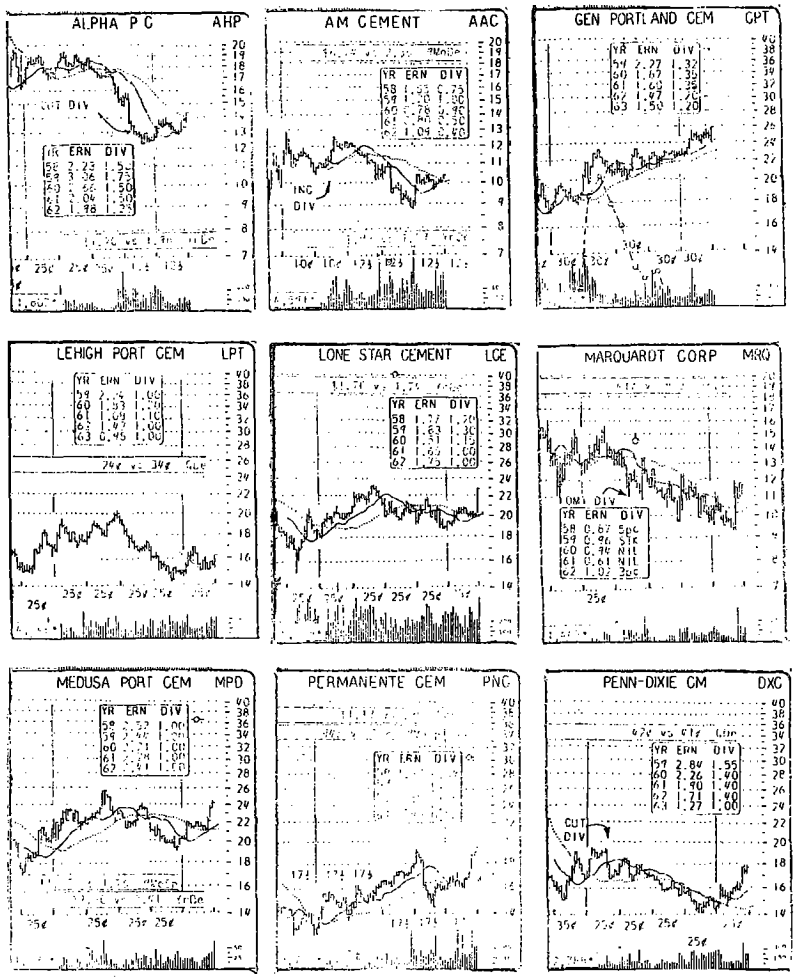
A second phenomenon discussed in previous Letters is the poor action of leading investment trusts on the N.Y.S.E. Almost all of them (such as Adams Express, Lehman, Madison Fund, General Amer. Investors) are now below their 10-week averages, and this action is so poor that it has me puzzled. The highly sensitive Tri-Continental Warrants, after touching a peak of 41 3/8 in late 1963, have moved sideways but refused to better their 1963 high (see chart). The TY Warrants have almost always been an excellent medium for participation in an important market movement (either way), and the long period of dullness in this issue gives one pause.

A great many subscribers took positions in Bullard as originally discussed in Letter 246 (price was 18 1/2). In the month since then, the stock has risen an amazing 50% (chart on page 4) and subscribers are asking what to do now. My advice would be to hold. The stock is moving out of what I believe to be the largest "inverse head-and-shoulders" base on the Board and its R.S. line is confirming the move. Head-and-shoulders patterns often provide an accurate "measurement" as to

the extent of the forthcoming move. Thus the same distance from the bottom of the head to the "neckline" or breakout level should be approximated by the stock on the current rise above the neckline. This measures to about 33-34 or almost double the original purchase price. At that level, I would begin taking some profits, and in case of a general market reversal I certainly would take profits anyway.



Where else can one try to make money? A group which I have been watching is the Cements. This group has been declining steadily in R.S. since 1958 (!) and is one of the few real "value" groups on the Board. I do not have the latest figures on this group's R.S. but it is very close to reversing. Of 11 larger cement companies listed on the N.Y.S.E., I counted 9 now rising above their 30-week moving averages, and most of this action has come comparitively recently. Highest Standard & Poor ratings for these stocks are A minus for LCE, MRQ, MDP and PNC. Almost all of these issues are now low-priced issues — but this was not always the case. For instance, Alpha Portland sold for 47 in 1956, at which time it earned $3.75. General Portland sold for 44 in 1959 and earned $2.27. Lehigh Portland sold for 58 in 1956 and earned $2.82. Penn-Dixie sold for 43 in 1956 and earned $2.97, and so forth. Most of these stocks now sell on a yield basis (a rarity in today's market), and they should participate in any further upside market progress (they should also be rather resistant to a general market decline, since they have been in a declining trend of popularity themselves for six years).



In January (Letter 243) I drew attention to the breaking of the major trendline under the fantastic "stilt" formation in Chrysler. Since then, it appears to me that the stock has recorded a "triple top" in the form of a rare "flat-top broadening formation." Note that the three peaks (1, 3, 5) are roughly parallel in the 49 area while point 4 is below point 2. Such a formation should be treated in the same manner as the orthodox broadening top. Note the decline in volume on the recent approach to the high. I feel Chrysler is a short with a "stop-buy" at 52.

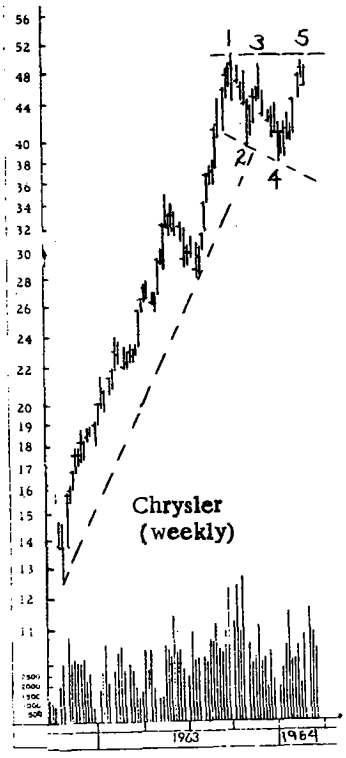


Chart 1 and charts of BLD and C courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003. Charts of GM, TY Warrants and all cements courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas. In answer to many inquiries, I use only charts which are scaled to semi-logarithmic or "ratio" proportions. I consider arithmetic charts difficult to work with, and I feel that in many instances they can be downright deceptive. Since no charting service can provide everything, I often combine information from two or more services for the benefit of readers.